

**Significant Efforts Have Been Made to Combat  
Abusive Trusts, But Additional Improvements  
Are Needed to Ensure Fairness and  
Compliance Objectives Are Achieved**

**February 2002**

**Reference Number: 2002-30-050**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

February 27, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Significant Efforts Have Been Made to  
Combat Abusive Trusts, But Additional Improvements Are  
Needed to Ensure Fairness and Compliance Objectives Are  
Achieved (Audit # 200130014)

This report presents the results of our review of the Internal Revenue Service's (IRS) efforts to combat abusive trusts. The overall objective of this review was to determine whether the IRS has an effective program to identify domestic trusts with a potential for noncompliance.

In summary, since 1997 the IRS has made significant efforts to combat abusive trusts. It has addressed abusive trust issues through a national strategy that includes the IRS Criminal Investigation function, the Small Business/Self-Employed (SB/SE) Division's Compliance function, the Office of Chief Counsel, and the Department of Justice. The IRS has emphasized the identification of abusive trust promotions and the use of civil and criminal enforcement actions. Further, the IRS has increased its examination of U.S. Income Tax Returns for Estates and Trusts (Forms 1041) from 567 in Fiscal Year (FY) 1997 to over 4,400 in FY 2000. As a result, proposed tax assessments involving abusive trusts and related returns increased from \$8 million in FY 1997 to over \$467 million in FY 2000.

Additional improvements are needed, however, to ensure that the IRS achieves its goal of combating abusive trusts. First, the assessment of penalties may vary depending on the facts and circumstances of, and the IRS examiner working on, the case. A review of abusive trust-related returns from the IRS' Audit Information Management System, closed during the first quarter of FY 2001, showed that the IRS may not be consistently

assessing the accuracy-related penalty.<sup>1</sup> The review showed the IRS assessed the accuracy-related or fraud penalty on only 26 percent of the returns. If the IRS assessed the accuracy-related penalty based on the additional tax assessments of \$467 million, additional penalty assessments could range from an estimated \$69.1 to \$138.2 million over a 2-year period. Second, one of the methods that the IRS' National Trust Initiative uses to accomplish its primary goal of combating abusive trusts is pre-filing and outreach activities. However, the IRS does not have performance measures to determine if its pre-filing and outreach activities are increasing taxpayer compliance. Finally, the IRS does not have a system to capture results of Form 1041 examinations that would identify emerging abusive trust issues.

Management's Response: IRS management has agreed to the recommendations presented and is proposing a number of actions to address the problems identified in our report. The Director, Compliance Policy, SB/SE Division, will develop new penalty tables to provide a tool for monitoring the application of the accuracy-related penalty; SB/SE Division Counsel will review the 1998 Advisory Opinion and determine whether updating and/or submitting it to the Office of Chief Counsel is needed; and the Director, Research, SB/SE Division, will consider a special study to analyze examination outcomes on unagreed cases and taxpayer behavior patterns after examination. Also, the Director, Compliance Policy, SB/SE Division, will develop a system to capture Form 1041 examination data.

Management did not fully concur with the outcome measures listed in the report and stated that each closed case would have to be reviewed to determine if the examiner had properly considered the accuracy-related penalty. The Commissioner, SB/SE Division, responded that since these were closed cases, the retrieval cost and time were prohibitive to make this determination.

Office of Audit Comment: The IRS does not maintain a system of records on proposed penalties. Our conclusions on the applicability of the accuracy-related penalty were based on a statistically valid random sample of closed cases, documentation from the IRS' Trust Forum that the penalty was being used as a "bargaining chip," examiners using the Office of Chief Counsel opinion to waive penalties as they see fit, and the IRS' Abusive Trust Guide (ATG). The significantly low rate of assessing the accuracy-related penalty (26 percent) suggests that the IRS, in contrast to the ATG, is not assessing the penalty in "most" cases. The ATG states, "In *most* abusive trust cases, either the negligence or substantial understatement penalty should be asserted against the grantor." (emphasis added) In addition, the ATG states, "reasonable cause for penalty abatement would not ordinarily be accepted."

Management's complete response to the draft report is included as Appendix VI.

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<sup>1</sup> 26 U.S.C. § 6662 (a) and (h) (1999) state the accuracy-related penalty is assessed at an amount equal to 20 percent of the underpayment or 40 percent for gross valuation misstatements.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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**Table of Contents**

Background .....	Page 1
Significant Efforts Have Been Made to Combat Abusive Trusts.....	Page 2
Consistency Is Needed in Assessing Penalties for Abusive Trusts .....	Page 4
<u>Recommendations 1 through 3:</u> ..... Page 7	
Performance Measures Are Needed to Help Ensure the Internal Revenue Service Is Meeting Its Goal to Combat Abusive Trusts .....	Page 8
<u>Recommendation 4:</u> ..... Page 9	
A System Is Needed to Capture Results of Form 1041 Examinations That Will Identify Emerging Abusive Trust Issues .....	Page 9
<u>Recommendation 5:</u> ..... Page 10	
Appendix I – Detailed Objective, Scope, and Methodology .....	Page 12
Appendix II – Major Contributors to This Report.....	Page 14
Appendix III – Report Distribution List .....	Page 15
Appendix IV – Outcome Measures .....	Page 16
Appendix V – Examples of Abusive Trusts.....	Page 17
Appendix VI – Management’s Response to the Draft Report .....	Page 18

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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**Background**

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According to the *Journal of Accountancy*,<sup>1</sup> more than \$4.8 trillion in wealth will be inherited or transferred from 1 generation to the next by the year 2015, with much of it transferred through a variety of trusts. A trust is a form of ownership that completely separates responsibility and control of assets from all the benefits of ownership. It is controlled and managed by a designated independent trustee.

The Internal Revenue Service (IRS) anticipates that almost 3.7 million U.S. Income Tax Returns for Estates and Trusts (Form 1041) will be filed for Calendar Year 2001. Trust returns are now the third most frequently filed income tax return, behind individual and corporate returns.

An abusive trust arrangement generally involves a promoter who claims that owners are allowed to both retain full benefit of business or personal assets and reduce or eliminate taxes. Abusive trust arrangements often involve more than one trust. For example, a person may put business assets in an unincorporated business trust, transfer business equipment to an equipment trust, place his or her home in a family residence trust, and set up a foreign trust to hold the other trust units and to receive trust income. Examples of abusive trusts are included in Appendix V.

The IRS has warned the public about abusive trust arrangements. IRS instructions for Form 1041 state that "Certain trust arrangements purport to reduce or eliminate Federal taxes in ways that are not permitted under the law." The instructions further state that "These promised benefits are inconsistent with the tax rules applicable to abusive trust arrangements."

We performed the audit at the Small Business/Self-Employed (SB/SE) Division Headquarters in Washington, D.C. We also visited the IRS offices in Dallas, Texas, and Denver, Colorado. The audit was

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<sup>1</sup> *Journal of Accountancy*, "Not All Trusts Are Trustworthy" (Special Report) by Dale Hart, September 1999.

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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### **Significant Efforts Have Been Made to Combat Abusive Trusts**

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performed between February and August 2001 in accordance with *Government Auditing Standards*.

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Since 1997, the IRS has made significant efforts to combat abusive trusts. Abusive trust issues are being addressed through a nationally coordinated strategy that includes the IRS Criminal Investigation function, the SB/SE Division's Compliance function, the Office of Chief Counsel, and the Department of Justice. The IRS has emphasized the identification of abusive trust promotions and the use of civil and criminal enforcement actions.

Further, the IRS established a National Trust Initiative to promote fairness to all taxpayers by addressing areas of noncompliance. The National Trust Initiative developed goals to:

- Examine additional trust returns and conduct research to help identify compliance trends among trusts.
- Identify and prosecute promoters of fraudulent trust schemes.
- Inform the public about the use of trusts and how to identify abusive trust schemes.
- Enhance the skills of examiners on trust issues.

To meet the goal to examine additional returns, the SB/SE Division's Compliance Policy function has committed additional staff to the Abusive Trust Program. The function allocated 96 direct Compliance staff years during Fiscal Year (FY) 2001, which represented an increase of 21 percent over FY 2000.

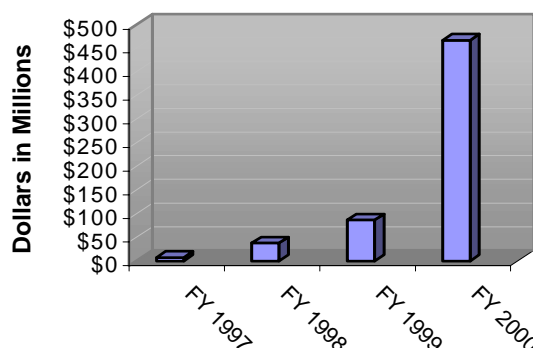
Committing these additional resources enabled the IRS to increase its examinations of Forms 1041 from 567 in FY 1997 to over 4,400 in FY 2000. These additional examinations yielded a substantial increase in proposed tax assessments, averaging \$104,000 per return. Figure 1

## Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved

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shows that IRS tax assessments involving abusive business trusts and related returns have increased from \$8 million in FY 1997 to over \$467 million in FY 2000.

**Figure 1. Proposed Tax Assessments for Abusive Business Trusts and Related Returns**



*Source: Project Code 233 Analysis as of September 2000 provided by the National Trust Initiative.*

The SB/SE Division's Strategy, Research and Performance Management function is performing a Grantor and Non-Grantor Domestic Trust Research Study.<sup>2</sup> The purpose of this study is to provide compliance information on taxpayers filing Forms 1041 with Beneficiary's Share of Income, Deductions, Credits, etc. (Schedule K-1), in order to profile the trust market segments, size the abusive trust market, and identify emerging issues. To date, the research group has determined the number of abusive trusts to involve between 5,000 and 10,000 tax returns.

To identify the promoters of abusive trusts, the SB/SE Division's Reporting Compliance function established an Abusive Tax Shelter web site, exclusively for the use of IRS

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<sup>2</sup> The Non-Grantor trusts are sub-divided into five categories: Business returns (Schedule C), Farm returns (Schedule F), Capital Gains (Schedule D), Supplemental Income (Schedule E), and Simple Trusts with Charitable Deductions. Grantor trust returns provide only the name and address of the trustee.



## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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employees, that details information on abusive trusts. The web site also contains a database link that collects information on promoters of abusive trusts. As of June 2001, the SB/SE Division's Reporting Compliance function had identified 35 promoters of abusive domestic trusts; an additional 53 leads involving promoters were being analyzed.

The IRS has been involved in various pre-filing and outreach activities to inform the public regarding abusive trust arrangements. Some of these activities involve public speaking engagements, television interviews, magazine and newspaper articles, Form 1041 instructions, notices, and brochures.

As a way to enhance the skills of examiners and share knowledge, a Trust Forum is available on the Intranet web site, which allows IRS employees to post questions on trust issues. Any employee experienced in the subject matter can answer these questions. The SB/SE Division's Reporting Compliance function management anticipates their staff will use this web site to share knowledge and experiences with other employees nationwide. In addition, management anticipates the result will help ensure uniform taxpayer treatment when performing trust examinations.

In another effort to enhance the skills of examiners, the SB/SE Compliance function has also provided employees the opportunity to enhance their technical skills through several trust-related training courses. For example, in FY 2000, 24 courses were conducted covering Fiduciary Income Tax, Abusive Trusts, Trust Law, and Foreign and Offshore Entities. As of June 2001, an additional 41 classes had been conducted.

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### **Consistency Is Needed in Assessing Penalties for Abusive Trusts**

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One of the IRS' Strategic Goals is to ensure that the law is applied fairly and uniformly to all taxpayers. The IRS uses penalties to ensure fairness of the tax system by justly penalizing the noncompliant taxpayer.

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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The IRS' policy<sup>3</sup> on penalty administration requires "...a penalty system that is designed to ensure consistency and accuracy of results in light of the facts and the law." The IRS' Abusive Trust Guide (ATG) recommends, "In most abusive trust cases, either the negligence or substantial understatement penalty should be asserted against the grantor."<sup>4</sup> The Guide also states that negligence is defined in the Internal Revenue Code (I.R.C.) as any careless, reckless, or intentional disregard of the rules and regulations or a failure to make a reasonable attempt to comply with the tax code.

However, the assessment of penalties for trust returns may vary depending on the facts and circumstances of, and the examiner working on, the case. The IRS' examiners in at least two locations have expressed their concern about conflicting guidance on assessing accuracy-related penalties.<sup>5</sup> For example, in the IRS Trust Forum, two examiners from two of the IRS' former District Offices stated that penalties were being used as a "bargaining chip" in their respective districts.

The IRS does not maintain a system of records on proposed penalties. A review of 162 randomly selected<sup>6</sup> abusive trust-related returns from the IRS' Audit Information Management System, closed during the first quarter of FY 2001, showed that the IRS may not be consistently asserting the accuracy-related penalty. On 103 cases where additional tax was assessed, the IRS assessed the accuracy-related or fraud penalty in only 27 (26 percent) cases. In FY 2000, the Abusive Trust Program proposed over \$467 million in additional tax assessments on 4,484 tax returns. These proposed assessments averaged \$104,208 per return. If this ratio of assessing the accuracy-related penalty

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<sup>3</sup> IRS Policy Statement P-1-18 (2000).

<sup>4</sup> The grantor is the creator of the trust and is generally the owner of the assets initially contributed to the trust.

<sup>5</sup> 26 U.S.C. § 6662 (a) and (h) (1999) state the accuracy-related penalty is assessed at an amount equal to 20 percent of the underpayment or 40 percent for gross valuation misstatements.

<sup>6</sup> Confidence level of 95 percent with a precision of  $\pm 3$  percent.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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is representative of the population, then an additional \$69.1 to \$138.2 million<sup>7</sup> in penalties also could have been assessed over a 2-year period.

In our opinion, conflicting guidelines may be causing this infrequent and inconsistent assessment of penalties on abusive trust cases. Specifically, in contrast to the IRS policy and the ATG, examiners may have been waiving the penalties as they see fit based on an Advisory Opinion issued by the IRS' Office of Chief Counsel in the former Western Region. The advisory opinion states in part,

*...if a taxpayer voluntarily amends his returns or cooperates with the IRS in settling the cases during the audit process, the examiner has the option of waiving such penalties as they see fit. However, if the taxpayer does not cooperate and the case is closed unagreed, appropriate penalties will be assessed.*

The Advisory Opinion that is being used as the basis to not assess appropriate penalties may, in fact, have very limited authority. The Advisory Opinion was issued in response to a “question concerning settlement of penalties against taxpayers who participate in abusive trust schemes” submitted by the former Western Region Trust Coordination Committee. This Advisory Opinion was not issued through the National Office of Chief Counsel for a formal Chief Counsel Advice (CCA) document.

I.R.C. § 6110 provides for the public inspection of Office of Chief Counsel determinations, including rulings, determination letters, technical advice, and memoranda. While CCA documents are not legal precedent, the Congress believed the public was entitled to know the rules applied in its dealings with the IRS. The Congress wanted all taxpayers to have access to the “considered view of the

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<sup>7</sup> The percentage of penalty assessed depends upon the circumstances involved.

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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Office of Chief Counsel's national office on significant tax issues."<sup>8</sup>

Without a consistent approach for assessing penalties, the IRS cannot ensure that penalties for taxpayers are fairly or consistently applied. In addition, there is a risk that not penalizing these taxpayers could result in further noncompliance because they may simply move to other abusive arrangements.

### **Recommendations**

The SB/SE Division's Director, Compliance Policy, should:

1. Ensure the Abusive Trust Program consistently applies the accuracy-related penalty in accordance with IRS policy, to help ensure fair and equitable taxpayer treatment.
2. Provide examiners with formal guidance on the appropriate application of the accuracy-related penalty, to help ensure its consistent application.
3. Request that the Advisory Opinion issued by the Office of Chief Counsel in the former Western Region be reviewed by the IRS' Headquarters Office of Chief Counsel, to help ensure fairness to all taxpayers and compliance with provisions of I.R.C. § 6110.

Management's Response: The Director, Compliance Policy, is developing new Penalty Tables to provide a tool for monitoring the application of the I.R.C. § 6662 penalty.

The SB/SE Division Counsel will review the 1998 Advisory Opinion and determine whether updating and/or submitting it to the Office of Chief Counsel is needed.

Management did not fully concur with the outcome measures listed in the report and stated that each closed case would have to be reviewed to determine if the examiner had properly considered the accuracy-related penalty. The

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<sup>8</sup> House of Representatives Conference Report to Accompany H.R. 2676, H.R. 105-599, (Page 298).

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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Commissioner, SB/SE Division, responded that since these were closed cases, the retrieval cost and time were prohibitive to make this determination.

Office of Audit Comment: The IRS does not maintain a system of records on proposed penalties. Our conclusions on the applicability of the accuracy-related penalty were based on a statistically valid sample of closed cases, documentation from the IRS' Trust Forum that the penalty was being used as a "bargaining chip," examiners using the Office of Chief Counsel opinion to waive penalties as they see fit, and the IRS' ATG. The significantly low rate of assessing the accuracy-related penalty (26 percent) suggests that the IRS, in contrast to the ATG, is not assessing the penalty in "most" cases. The ATG states, "In *most* abusive trust cases, either the negligence or substantial understatement penalty should be asserted against the grantor." (emphasis added) In addition, the ATG states, "reasonable cause for penalty abatement would not ordinarily be accepted."

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### **Performance Measures Are Needed to Help Ensure the Internal Revenue Service Is Meeting Its Goal to Combat Abusive Trusts**

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The IRS has been involved in various pre-filing and outreach activities to educate the public regarding abusive trust arrangements. However, the IRS does not have a method to determine if its pre-filing and outreach activities are actually increasing taxpayer compliance.

For example, the IRS uses the success of its pre-filing and outreach activities as a measure in its compliance program. However, a decrease in the number of abusive trust returns does not necessarily mean there is an increase in overall compliance. Rather, these taxpayers may have found new ways to shelter their income through other abusive arrangements.

The Government Performance and Results Act of 1993 (GPRA)<sup>9</sup> required agencies to set performance goals and report annually on actual performance compared to these goals. Without effective measures to determine the success of its activities, the IRS risks losing the opportunity to

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<sup>9</sup> Pub. L. No. 103-62, 107 Stat. 285.

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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effectively communicate and educate the public. This may result in less revenue collected.

The IRS has acknowledged in its Strategic Plan that it does not have reliable, up-to-date measures of overall compliance. Enforcement revenue has been used as a strategic measure. However, enforcement revenue figures do not provide an overall measurement of changes in taxpayer compliance.

### **Recommendation**

4. The SB/SE Division's Director, Reporting Compliance, should identify compliance measures that will determine not only changes in the abusive trust compliance levels but also whether the taxpayer behavior has actually changed.

Management's Response: The SB/SE Division's Research function is considering a special study to analyze follow-up years for Abusive Trust cases closed in FY 2000. This study will analyze examination outcomes on unagreed cases closed to Appeals, Collection outcomes, and taxpayer behavior patterns after examination.

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### **A System Is Needed to Capture Results of Form 1041 Examinations That Will Identify Emerging Abusive Trust Issues**

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Abusive trust arrangements are varied and difficult to identify using the current IRS systems. In particular, the IRS does not have a system to track and identify emerging abusive trust issues. Changes in tax laws, technology, filing patterns, and trends have created the need for the IRS to update and modify its approach to addressing abusive trusts.

For example, procedures for classifying trust tax returns had not been updated for more than 20 years. In January 2001, as part of the National Trust Initiative, the IRS updated its Form 1041 Classification Guide and Desk Reference to assist classifiers and examiners in identifying potential audit issues on trust tax returns. However, the classification of Forms 1041 is not automated and continues to be a labor-intensive process.

This has occurred because current data collection systems used by the IRS do not provide managers with the necessary

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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information to effectively identify emerging issues and assist with the allocation of examination resources. The IRS uses the Midwest Automated Compliance System (MACS), which contains information from tax returns posted to the IRS' Masterfile.<sup>10</sup> Although this system includes all filed returns, it does not have analytical tools for return selection.

Likewise, the IRS uses the Audit Information Management Systems (AIMS) to maintain and control its examination inventory. Project codes are used to identify known issues for the returns selected for examination. However, these codes do not provide for the identification of new issues identified during the examination.

The General Accounting Office's *Standards for Internal Control in the Federal Government* state, "Program managers need both operational and financial data to determine whether they are meeting their agencies' strategic and annual performance plans and meeting their goals for accountability for effective and efficient use of resources." It further states, "Pertinent information should be identified, captured, and distributed in a form and time frame that permits people to perform their duties efficiently."

Without pertinent information on abusive trust issues, the IRS will have difficulty in determining its success in reducing abusive trusts and preventing future non-compliance. In addition, the IRS will not be able to effectively plan and allocate its resources to maximize examination results.

### **Recommendation**

5. The SB/SE Division's Director, Compliance Policy, should develop a system to capture the results of

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<sup>10</sup> The Masterfile is the IRS' main computer system that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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Form 1041 examinations that would provide management with information to help identify emerging abusive trust issues and future noncompliance and to help allocate resources to maximize audit results.

Management's Response: Compliance Policy and Support Services are developing an experimental system to capture Form 1041 examination data.



**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
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**Appendix I**

**Detailed Objective, Scope, and Methodology**

Our overall objective was to determine whether the Internal Revenue Service (IRS) has an effective program to identify domestic trusts with a potential for noncompliance. Specifically, we evaluated the methodology that the IRS has to increase taxpayer compliance. In addition, we evaluated the system the IRS uses to measure the results of its efforts in reducing noncompliance and identifying potential areas for examination. The following steps were performed to accomplish the audit objective:

- I. To determine what methodology the IRS had planned to increase taxpayer compliance, we:
  - A. Reviewed the IRS' Communication Plan to determine if the IRS has developed an effective outreach program for educating the public about abusive trusts to increase voluntary compliance.
  - B. Determined methods used to disseminate information to the public regarding abusive trusts.
- II. To determine if the IRS had a system for determining appropriate treatment of abusive trusts, measuring the effectiveness in reducing noncompliance and identifying potential areas for examination, we:
  - A. Interviewed the IRS' Small Business/Self-Employed (SB/SE) Division's Compliance function management to determine if the IRS has planned an effective management information system to measure the success of its efforts in reducing noncompliance and protecting revenue.
  - B. Interviewed the SB/SE Division's Compliance function management to determine whether the IRS has developed a nationwide classification system that would identify potential areas for abusive trusts and aid in the selection of U. S. Income Tax Returns for Estates and Trusts (Form 1041) for examination.
  - C. Reviewed the Internal Revenue Manual, the IRS' Abusive Trust Guide, the Internal Revenue Code, and instructions available on the IRS' Intranet web sites for determining the appropriate use of penalties for abusive trust cases.
  - D. Selected a statistically valid random sample of 162<sup>1</sup> from a universe of 789 abusive trust-related returns on the IRS' Audit Information Management System, closed

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<sup>1</sup> Confidence level of 95 percent with a precision of  $\pm 3$  percent.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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during the first quarter of Fiscal Year 2001, and analyzed Masterfile<sup>2</sup> data to determine if the accuracy-related or fraud penalty was assessed on those returns with additional tax assessments. The actual closed case files were not reviewed to determine whether the penalty was considered.

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<sup>2</sup> The Masterfile is the IRS' main computer system that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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**Appendix II**

**Major Contributors to This Report**

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Philip Shropshire, Director

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Carole E. Connolly, Senior Auditor

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**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner, Small Business/Self-Employed Division S:DC  
Chief Counsel, Small Business/Self-Employed Division S:CC  
Director, Compliance, Small Business/Self-Employed Division S:C  
Director, Customer Account Services, Small Business/Self-Employed Division S:CAS  
Director, Internal/External Stakeholders, Compliance Policy, Small Business/Self-Employed  
Division S:C:CP:I  
Director, Reporting Compliance, Small Business/Self-Employed Division S:C  
Director, Taxpayer Education and Communication, Small Business/Self-Employed  
Division S:TEC  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:F:M  
Audit Liaisons:  
Commissioner, Small Business/Self-Employed Division S  
Director, Compliance, Small Business/Self-Employed Division S:C

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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**Appendix IV**

**Outcome Measures**

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; \$69.1 million in penalties assessed on abusive trust tax returns; over a 2-year period, \$138.2 million (see page 4).

Methodology Used to Measure the Reported Benefit:

The IRS does not maintain a system of records on proposed penalties. We selected a statistically valid random sample of 162<sup>1</sup> from a universe of 789 abusive trust-related returns from the Internal Revenue Service's (IRS) Audit Information Management System's closed examinations for the first quarter of Fiscal Year (FY) 2001. On 103 cases where additional tax was assessed, the IRS assessed the accuracy-related<sup>2</sup> or fraud penalty on only 27 tax returns (26 percent). In the remaining 76 returns (74 percent), the accuracy-related or fraud penalty was not assessed.

In FY 2000, the Abusive Trust Program proposed over \$467 million in additional tax assessments on 4,484 tax returns. The proposed assessments averaged \$104,208 per return. The total applicable accuracy-related penalty (20 percent) on the \$467 million in additional tax assessment would be approximately \$93.4 million. When this ratio of assessing the accuracy-related penalty is applied to the \$467 million assessed in FY 2000, then IRS could have assessed approximately \$69.1 million (74 percent of the \$93.4 million) in additional penalty assessments. We applied the ratio of assessing the accuracy-related penalty because there was no evidence that the processes and procedures had changed between FY 2000 and the first quarter of FY 2001. For purposes of determining quantifiable outcome measures, we used the lower percentage (20 percent) for the accuracy-related penalty amount that could be assessed.

Finally, the IRS' practice of infrequently assessing the accuracy-related penalty continued through FY 2001. Therefore, we calculated the outcome measure for a 2-year period to be approximately \$138.2 million (\$69.1 million for each year).

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<sup>1</sup> Confidence level of 95 percent with a precision of  $\pm 3$  percent.

<sup>2</sup> 26 U.S.C. § 6662 (a) and (h) (1999) state the accuracy-related penalty is assessed at an amount equal to 20 percent of the underpayment or 40 percent for gross valuation misstatements.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
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Achieved**

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**Appendix V**

**Examples of Abusive Trusts**

**Business (or Unincorporated Business) Trust**

The owner of a business transfers the business to a trust. The business trust then makes payments, which are characterized as deductible business expenses or deductible distributions, to “unit holders.” These payments reduce the amount of taxable income, which results in little or no tax being due.

**Equipment or Service Trust**

An equipment trust is formed to hold equipment that is rented or leased to the business trust, often for inflated rates. The business trust then reduces its income by claiming deductions for payments to the equipment trust.

**Family Residence Trust**

The owner of the family residence transfers the residence, including furnishings, to a trust. The trust claims to be a rental business and rents the residence to the owner, who is the caretaker of the property. The trust may attempt to deduct depreciation and the expenses of maintaining and operating the residence.

**Charitable Trust**

The owner transfers assets or income to a trust claiming to be a charitable organization. The trust or payments made by the owner to the “charitable organization” pay for personal, educational, or recreational expenses. The payments are then claimed as “charitable” deductions.

**Foreign Trust**

These trusts often are located in foreign countries that impose little or no tax on trusts and also provide financial secrecy. Typically, abusive foreign trust arrangements enable taxable funds to flow through several trusts or entities until the funds are ultimately distributed or made available to the original owner. The trust promoter claims that this distribution is tax-free. In fact, the income from a foreign trust arrangement is fully taxable.

**Significant Efforts Have Been Made to Combat Abusive Trusts, But  
Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are  
Achieved**

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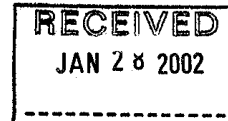
**Appendix VI**

**Management's Response to the Draft Report**



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

JAN 28 2002



**MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT**

**FROM:** Joseph G. Kehoe  
Commissioner, Small Business/Self-Employed

**SUBJECT:** Draft Audit Report – Ensure the Abusive Trust Program  
Consistently Applies the Negligence Penalty in  
Accordance with IRS Policy, to Help Ensure Fair and  
Equitable Taxpayer Treatment (200130014)

I have reviewed your report and am providing my comments on your audit of the Abusive Trust Program. I agree we need to make additional improvements to ensure the IRS achieves its goal of combating abusive trusts. To that end, we will undertake the following actions:

- Development of new Penalty Tables
- Review of 1998 Advisory Opinion regarding waiver of penalties
- Study of follow-up years for Abusive Trust cases closed in FY 2000
- Development of experimental system to capture 1041 examination data.

My detailed comments on the report's recommendations follow:

**RECOMMENDATION 1:** Ensure the Abusive Trust Program consistently applies the negligence penalty in accordance with IRS policy, to help ensure fair and equitable taxpayer treatment.

**ASSESSMENT OF CAUSE:** The tables used by Examination do not separately state penalties proposed by return type or project type. The Abusive Trust Program for FY 2000 proposed over \$467 million in additional tax assessments. If IRC section 6662 applied to the total proposed tax of \$467 million, the maximum negligence penalty assessments would be approximately \$93.4. However, the IRC 6662 penalty is a factual determination of negligence and would not apply to all Abusive Trust examinations. It would be inappropriate to require a rote determination of negligence on every Abusive Trust case. Examiners are required to consider IRC 6662 in each Abusive Trust case and determine its applicability. The IRS reports did not provide enough detail to determine in how many cases the penalty was applied or the total amounts of penalty applied. A review of 162 closed Trust cases by the TIGTA examiner did determine that IRC 6662 was being applied in some cases. Those cases where

## **Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved**

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the penalty was not applied would require a physical review of each closed case, to determine if the examiner had properly considered the penalty. This was not done, as these are closed cases, and retrieval cost and time were prohibitive for such an action. However, the sample Quality Review Program within SB/SE is designed to detect such trends and current reports have not indicated a problem with IRC section 6662 consideration or application.

**CORRECTIVE ACTION:** The Director, Compliance Policy is developing new Penalty Tables to provide a tool for monitoring the application of the IRC 6662 penalty.

**IMPLEMENTATION DATE:** September 30, 2002

**RESPONSIBLE OFFICIAL:** Director, Compliance Policy

**CORRECTIVE ACTION MONITORING PLAN:** Program Manager for Penalties and Interest, within Compliance Policy, will monitor and update SB/SE Management of any delay, change, or problem with the implementation.

### **RECOMMENDATIONS 2 & 3:**

1. Provide examiners with formal guidance on the appropriate application of the negligence penalty, to help ensure its consistent application.
2. Request that the Advisory Opinion issued by the Office of Chief Counsel in the former Western Region be reviewed by the IRS' Headquarters Office of Chief Counsel, to help ensure fairness to all taxpayers and compliance with provisions of I.R.C. § 6110.

**ASSESSMENT OF CAUSE:** Examination has different guidelines on penalty policy for agreed and unagreed examinations on abusive trust cases. Specifically, since 1998, a settlement initiative allowed examiners an option to waive the Negligence penalty in agreed cases. The IRS' former Western Region Counsel, issued an Advisory Opinion that established:

"If a taxpayer voluntarily amends his returns or cooperates with the Examination Division in settling the cases during the audit process, the Examination Division has the option of waiving such penalties as it sees fit. Exam must also secure a closing agreement in settled cases." IRS initiated this policy to enhance collection of tax due, to expedite the assessment process, and lower the cost of examination.

**CORRECTIVE ACTION:** We agree the SB/SE Division Counsel will review the 1998 Advisory Opinion and determine whether updating and/or submission to Office of Chief Counsel is needed.

**IMPLEMENTATION DATE:** SB/SE Division Counsel will complete the review process by September 30, 2002.



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RESPONSIBLE OFFICIAL: Division Counsel (SBSE)

CORRECTIVE ACTION MONITORING PLAN: Program Manager for Flow-Through Entities, within Compliance Policy, will monitor and update SB/SE Management of any delay, change, or problem with the implementation.

**RECOMMENDATION 4:** The SB/SE Division's Director, Reporting Compliance, should identify compliance measures that will determine not only changes in the abusive trust compliance levels, but also whether the taxpayer behavior has actually changed.

ASSESSMENT OF CAUSE: Current tables and reports do not monitor taxpayers' future behavior.

CORRECTIVE ACTION: SB/SE Research is considering a special study in the Abusive Trust area to analyze follow-up years for Abusive Trust cases closed in FY2000. This study will analyze examination outcomes on unagreed cases closed to Appeals, Collection outcomes, and taxpayer behavior patterns after examination.

IMPLEMENTATION DATE: The Research Project, if approved, will begin April/May 2002, and we expect to complete it December 2002.

RESPONSIBLE OFFICIAL: Director of SB/SE Research

CORRECTIVE ACTION MONITORING PLAN: Program Manager for Flow-Through Entities, within Compliance Policy, will monitor and update SB/SE Management of any delay, change, or problem with the implementation.

**RECOMMENDATION 5:** The SB/SE Division's Director, Reporting Compliance, should develop a system to capture the results of Form 1041 examinations that would provide management with information to help identify emerging abusive trust issues and future noncompliance and to help allocate resources to maximize audit results.

ASSESSMENT OF CAUSE: The current RGS system does not capture data from closed 1041 examinations. AIMS project codes do separate closures by ten general categories.

CORRECTIVE ACTION: Compliance Policy and Support Services are developing an experimental system to capture 1041 examination data. The project involves developing 1041 tax computation and information capturing software for the Intranet. For this project, we are seeking to combine commercial software with our current systems.

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IMPLEMENTATION DATE: Fiscal Year 2003

RESPONSIBLE OFFICIAL: Director, Compliance Policy

CORRECTIVE ACTION MONITORING PLAN: Program Manager for Flow-Through Entities, within Compliance Policy, will monitor and update SB/SE Management of any delay, change, or problem with the implementation.

If you have any questions, please call Martha Sullivan, Director of Compliance, Small Business/Self-Employed, at 202-283-2144.